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IN THIS ISSUE:

Japanese Economy Remains Firm Despite Investment Slowdown 1

Attention Focuses On Japan's Tax System 3

Stronger Yen Pushing Down Import Prices In Japan 4

Japan's Trade Surplus With Korea And Taiwan Rises 6

Trade Measures Proposed In Final Days Of 99th Congress 7

Congress Approves Defense-Related Requirements 8

Japan's Car Export Restraints: Testing The Waters 10

Japanese Economy Remains Firm Despite Investment Slowdown

The deflationary effects of the yen's appreciation continue to slow Japan's economy. Although export volume rose in September, it had declined from year-earlier levels for six consecutive months. The drop in export earnings in turn has depressed business investment and raised unemployment, which reached 2.9 percent of the labor force in both July and August, a postwar high. Still, the economy is unlikely to plunge into recession since major sectors, including personal consumption spending and residential construction, remain steady.

The research arms of Japan's four major securities firms have forecast double-digit declines in the pre-tax profits of major Japanese companies in FY 1986, primarily due to their failure to pass on currency changes in the form of higher export prices in order to maintain market share abroad. While the overall profit decline is estimated at between 10.9 percent and 14.5 percent, there is a large gap between export-oriented industries and those benefiting from the yen's rise. A 30 percent-plus decline in pre-tax profits is projected for the manufacturing sector, in contrast to a 10-13 percent increase for nonmanufacturing companies. The forecasts assume an exchange rate in the Y150-Y163=$1.00 zone as well as a fourth cut in the Bank of Japan's official discount rate.

The expected decline in corporate profits is likely to lower the normal growth in capital investment from FY 1985's 11.7 percent jump and FY 1984's 10.7 percent increase. Major Japanese banks predict a modest 3.4 percent to 7.6 percent rise in investment in plant and equipment in fiscal 1986 and are even less optimistic about the following year (see Table). The electric power industry, which has gained windfall profits from cheaper oil, is expected to account for a significant portion of the increase. The government has forecast a 7.1 percent rise in business investment for the current fiscal year.

Forecasts of Private-Sector Plant and Equipment Investment

(percentage change from preceding year)

	Bank of Japan	Japan Development Bank	Industrial Bank of Japan	Long-Term Credit Bank of Japan	Nippon Credit Bank
Fiscal Year 1986					
All industry	3.4%	5.4%	7.6%	6.1%	6.8%
excluding electric power	-2.2	3.1	5.6	2.6	3.6
Manufacturing industry	-6.1	-3.6	-6.0	-5.1	-7.4
Nonmanufacturing industry	14.6	12.0	14.0	13.4	13.4
excluding electric power	9.8	10.3	13.3	11.1	12.1
Fiscal Year 1987					
All industry	n.a.	-0.7	-1.3	0.1	0.9
excluding electric power	n.a.	-0.3	-1.1	0.6	1.7
Manufacturing industry	n.a.	-10.6	-8.6	-15.4	-6.7
Nonmanufacturing industry	n.a.	2.1	1.5	2.6	3.7
excluding electric power	n.a.	5.0	3.1	5.3	7.1

Source: Nihon Keizai Shimbun, October 2, 1986.

Despite the slowdown in the manufacturing sector, housing construction and other nonmanufacturing activities continue to support the economy. Housing starts in July, for example, were up 13.5 percent from a year earlier. The benefits of the yen's appreciation, the fall in oil prices and lower interest rates will help sustain Japan's economic expansion, which began in March 1983. Bank of Japan governor Satoshi Sumita said he is waiting to see what effect

these factors will have before deciding whether to lower interest rates again. Moreover, the present interest rate gap between the United States and Japan is about right, Mr. Sumita said, given this country's large financing needs.

Many economists, though, remain less optimistic about Japan's economic prospects. The International Monetary Fund predicts that inflation-adjusted growth will slow from 4.5 percent in 1985 to 2.6 percent this year. And Sumitomo Bank, Ltd. recently lowered its real growth forecast for FY 1986 by 0.5 percentage point to 2 percent. Tokyo, though, remains committed to its outlook of 4 percent real growth in FY 1986, hoping for a big boost from the economic stimulus package announced September 19. Work on the supplementary budget to fund the package is expected to be completed October 24 and will be submitted to the Diet late this month.

Randall S. Jones

Attention Focuses On Japan's Tax System

Spurred by the passage of a sweeping U.S. tax reform package, Japan is moving toward an equally significant restructuring of its tax system. In preparation for the opening of the Diet's next regular session in December, the government's Tax System Council has been putting together a final report on tax reform. Bits and pieces of the final plan are coming to light as intense debates within the council and around the nation continue to evolve. To complicate the tax writers' problems, a personal income-tax cut has been proposed and a big supplementary FY 1986 budget is expected to be approved shortly, increasing fiscal pressures.

The Japanese have several long-standing complaints about the tax system. While salaried workers have income taxes deducted at the source, self-employed individuals report their own income and calculate their tax liability, leading to significant tax avoidance by farmers and small businesses. Big business, on the other hand, has constantly argued that Japan's corporate income tax rate of 43.3 percent (33.3 percent on income distributed as dividends) is high by international standards. Since local taxes add almost another 10 percent, corporations see half of their profits go to the government's coffers. Finally, regulations that grant tax-free status to interest on savings of up to Y14 million ($90,300 at Y155=$1.00) are widely abused by individuals who open more than the single account permitted by law, engendering calls for reform or abolition of the exemption.

Since September, a year after Prime Minister Yasuhiro Nakasone charged the Tax System Council with drawing up a tax reform package, the outlines of the plan have been aired in public. Personal and corporate income-tax rates would be slashed. The top bracket for individuals would drop from 70 percent to 50 percent. Including local taxes, the top wage earners would face a marginal rate of 60 to 70 percent. A reduction in the number of brackets from the current 15 is also contemplated to make pay raises more attractive by reducing the progressiveness of the rates.

A single rate of 35 percent is being suggested to replace the two-tier corporate income-tax structure. The Economic Planning Agency calculates that

the reduction could inflate capital spending by as much as 8 percent annually over the next four years. The proposal has certainly received an enthusiastic reception from the private sector.

To pay for these reductions, one simple and several complex ideas have been circulated. The most popular of these proposals would alter the income reporting regulations so that self-employed taxpayers would find it more difficult to avoid taxes. The possibility of one or more indirect taxes, though, has generated some debate. During the 1986 Diet elections, Mr. Nakasone ruled out a European-style value-added tax. The Tax System Council has raised three alternatives: broadening the coverage of the commodity tax from the current 85 items to most final goods (excluding food as well as raw materials, machinery and goods used in manufacturing); instituting a single tax on products and services between the production and consumption stages (except for food, social security payments and inter-firm transactions); and imposing a tax on businesses based on the difference between their tax liability using sales data and the taxes paid on materials consumed in the manufacturing process (the so-called Japanese-style value-added tax). The indirect tax issue has split normally cohesive groups. Not surprisingly, business groups oppose one option and support others according to whether the tax ax will fall on them or on someone else. Political parties have also been divided by the issue, leading to more debate.

This conflict pales, however, in comparison to the discussion over the fate of the tax-free savings system (maruyu). Not only are small savers up in arms, but the Ministry of Posts and Telecommunications, which administers the Postal Savings System, is also lobbying hard to retain the tax exemption. On the other hand, the Ministry of Finance and the commercial banks and securities firms favor significant reform -- if not elimination -- of the system, the former because of the revenue-raising potential of an overhaul and the latter because it will eliminate a privileged competitor (the Postal Savings System). The issue has proven so sensitive that many previous attempts at reform have failed; it is not clear if Mr. Nakasone can succeed.

At any rate, the Tax System Council's final report will not be the last word on tax reform. With so many actors and so many interests participating, it is still unclear what legislation will be introduced in the upcoming regular Diet session for fiscal 1987 implementation.

Jon Choy

Stronger Yen Pushing Down Import Prices In Japan

The effect of the yen's 56 percent appreciation against the dollar since late September 1985 has at last managed to filter down through the many layers of the Japanese distribution system. An April government survey showed just half of the items checked were selling at lower retail prices, despite almost across-the-board declines in import prices (see JEI Report No. 23B, June 20, 1986). But a more recent survey indicated that retail prices on three-fourths of the items in the sample had been reduced. In addition, many Japanese retailers are strengthening their overseas buying operations to capitalize on the yen's higher value.

According to the Ministry of International Trade and Industry, of 41 items recently surveyed, 39 cost less to import and 33 sold at lower retail prices. As was the case in the earlier survey, retail prices fell more sharply than import prices in some cases, and less in others (see Table). The disparity is probably due to the time lags built into the system as well as varied pricing policy decisions by distributors and retailers. For example, retail prices of well-known brandname goods did not decline even though import prices fell, according to MITI. This may reflect the retailer's decision that price is not an important factor in sales of these popular products. In fact, for some premium foreign goods, price cuts would probably be counterproductive, destroying the cachet of exclusivity.

Selected Changes in Import and Retail Prices, June 1986*

(in yen and percentage change)

	Import Price Change	Retail Price Change	Percentage Change	Retail Price
Tuna (per kg)	Y-237	Y-300	-7.1%	Y3,930
Shrimp (per kg)	-577	-420	-8.4	4,590
Lemons (per kg)	-245	-899	-71.3	362
Bananas (per kg)	-9	13	5.0	274
Cacao beans (per kg)	-185	-10	-0.4	2,460
Whiskey (average grade)	-123 to -147	0 to -1,350	0 to -32.5	2,650 to 4,150
Wine (American)	-96 to -219	0 to -500	0 to -25.0	900 to 1,800
Records	-238	-175	-8.1	1,990
Golf club sets	-8,670	-32,000	-20.0	128,000
Watches	-3,432	0	0.0	224,000
Handbags	-1,852	-3,000	-7.0	40,000
Fountain pens	-1,332	0	0.0	60,000
Photographic film (roll)	0	0	0.0	530
Perfume (bottle)	0	0	0.0	15,000

*Changes calculated using August 1985 base prices.

Source: Ministry of International Trade and Industry

Although the retail price reductions are probably due to the normal -- but slow -- process of price changes working their way through the distribution network, Tokyo has been doing its best to jawbone retailers into passing on the benefits of the stronger yen. Prime Minister Yasuhiro Nakasone, who expressed concern over the sluggish reaction of retail prices when the first survey was conducted, instructed the cabinet to find ways to improve the situation. Forthwith, MITI, the Economic Planning Agency and others began to complain that consumers were not benefiting quickly enough. The Japan Fair Trade Commission even went so far as to initiate a study as to why retail prices were not changing in reaction to import price cuts.

Retailers themselves are beginning to make adjustments in light of what is apparently a permanent appreciation of the yen. Several major department stores have reorganized their foreign products purchasing departments into separate trading companies to take advantage of tax laws and more vigorously search for products to import. Other firms have added a purchasing office to their overseas stores to bolster import activities. A boom has gripped the trading business as more distributors are finding it worthwhile to open their own overseas offices. Finally, Tokyo continues to support these import drives with overseas and domestic programs. MITI has designated October, for example, as import promotion month.

Jon Choy

Japan's Trade Surplus With Korea And Taiwan Rises

The realignment of exchange rates during the past year has boosted the economies of Asia's newly industrialized countries by making their exports more competitive in world markets. In the year following the September 1985 Group of Five agreement, the yen appeciated 52 percent and 45 percent against the currencies of Korea and Taiwan, respectively, which are essentially linked to the dollar. The currency changes are a major reason for the 25 percent rise in Korea's aggregate exports during the first eight months of 1986. This export boom is expected to fuel real economic growth of about 9.5 percent and a record trade surplus of $2 billion in 1986. Similarly, Taiwan's overall exports in the June-August period were up 34 percent from a year earlier.

The appreciation of the yen has enabled Korea and Taiwan, Japan's sixth- and tenth-largest trading partners, respectively (based on two-way trade), to increase their sales to Japan during the first nine months of 1986 (see Table), in contrast to the overall decline in Japanese imports. Manufactured goods accounted for most of the increased purchases; imports of Korean textiles and steel in August, for example, were up 30 percent and 40 percent from a year earlier.

Japan's Trade with Korea and Taiwan

(in millions of dollars)

	1983	1984	1985	January-September 1985	January-September 1986
Exports					
Korea	$6,004	$7,227	$7,097	$5,026	$7,568
Taiwan	5,086	5,986	5,025	3,694	5,391
Imports					
Korea	3,365	4,213	4,092	2,958	3,544
Taiwan	2,622	3,204	3,386	2,471	3,198

Source: Japan Tariff Association

Exports to Korea and Taiwan rose 50.6 percent and 45.9 percent, respectively, in dollar terms during the January-September period, compared to a 21.6 percent increase in total Japanese exports. The sharp rise in shipments reflects both the J-curve effect, which makes a given quantity of exports more expensive in dollar terms, and the rapid pace of economic activity in the two developing countries, which increases their import volume. The rise in deliveries of machinery and equipment was especially sharp; shipments of office machinery to Taiwan and Korea in August 1986 were more than double the same month in 1985.

The changes in trade flows are exacerbating trade disputes, particularly between Japan and Korea. Japan's surplus with Korea, which totaled $3.4 billion during the January-September period, may reach $6 billion this year. Since the normalization of relations in 1965, Korea has accumulated $32.9 billion in trade deficits with Japan, a figure equivalent to 70 percent of its foreign debt. To reduce this imbalance, Seoul recently instructed domestic producers to find European and U.S. suppliers of 30 industrial, electronic and chemical products currently imported from Japan. But given Korean industry's dependence on Japanese capital and intermediate goods, it will be difficult to change sources of supply quickly. For example, half of the components of Korean-made video cassette recorders come from Japan.

Randall S. Jones

Trade Measures Proposed In Final Days Of 99th Congress

The adjournment date of the 99th Congress was repeatedly postponed as legislators concluded work on the appropriations resolution, budget reconciliation, drug legislation and immigration reform acts at an almost frantic pace. Throughout the rush, however, trade-conscious members attempted to push through at least some trade measures. Some of these, including "Buy America" provisions for machine tools and ball bearings (see article in this issue) as well as a Customs user fee, were enacted. Others -- for example, a miscellaneous tariff bill and a "Buy America" provision for oil rigs -- failed to achieve Senate approval.

U.S. trading partners watched the progress of a miscellaneous tariff bill (HR 5686) with great interest. The proposal, which would have affected tariffs on 83 categories of items as well as requirements for proceedings under Section 337 of the 1930 Tariff Act (patent infringement and other unfair trade practices), passed the House October 14 (see JEI Report No. 38B, October 17, 1986). Despite House appeals to the Senate, the measure never made it to a vote in the upper chamber. When a unanimous consent agreement was proposed to bring a revised version of the bill to a vote -- including deleting provisions concerning Section 337 cases and deleting tariff changes related to television apparatus and parts, watches and watch components -- the Senate refused to accept the bill without having an opportunity to introduce amendments.

The miscellaneous tariff bill would probably have passed the Senate if the legislators had been willing to use precious time for debate. However, by the week of October 13, pressures to adjourn had mounted. Legislators were anxiously watching their campaign opportunities slip away. Moreover, although